L. Roy Papp & Associates, LLP
Investment Counsel

2201 East Camelback Road
Suite 227B
Phoenix, Arizona 85016
(602) 956-0980
FAX: (602) 956-7053

VIEWS FROM CAMELBACK MOUNTAIN

Still Room For Charity

A little over a year ago, U.S. corporate and individual tax laws changed dramatically. There are, of course, some winners and losers. Many individuals have not given much thought to how the changes will impact them. Surprises may be in store as many folks file their 2018 income tax returns on April 15, 2019. Tax-payers will notice immediately that the familiar 1040 form has changed dramatically in format. You are also going to find out that the vast majority of American couples will no longer itemize deductions. For many, that means $2,000, $5,000, or even $10,000 of contributions given through the year to their favorite charities will effectively not be deductible. The standard deduction for couples is now $24,000 and only $10,000 of state income tax, sales tax and real estate taxes combined can be deducted. If a couple does not have a mortgage or major health expenses, there are now important charitable giving strategies that can still provide great tax benefits.

Many of these strategies are a little too complex to touch on in a two-page letter. For folks over the age of 70 ½, gifts directly from their IRA to a charity are often a great idea. For younger people, bunching charitable gifts into one big donation one year out of every four or five or alternatively funding a big gift to a donor advised fund, like the Arizona Community Foundation, which can then be spread out over four or five years may allow most of the donation to be deductible. The team here at L. Roy Papp and Associates includes experts in charitable gifting and tax planning. If you have questions, give us a call and we will be happy to run through the strategies that make the most sense in your particular situation. As you know, for our clients and friends, there are no charges for this advice. We here at L. Roy Papp & Associates are involved with and support a wide range of non-profits throughout the community so we are eager to help generous donors optimize the tax benefits from their donations.

We normally do not dwell on current economic and market conditions in our New Year's letter. Given the sharp market declines over the last few months, we want to address this. The markets are currently suffering a crisis of confidence and it is crystal clear that ground zero is 1600 Pennsylvania Avenue. The economy is currently doing very well. Unemployment is 3.7% which is a 50-year low and it is likely headed lower. GDP was up 4.2% annualized in the 2nd quarter and 3.4% in the 3rd quarter. It will probably come in north of 3% during the fourth quarter and it is hard to imagine that GDP growth in 2019 could be less than 2%. Corporate earnings will be up well above 20% during 2018 to a new all-time high and earnings will likely be up at least 8% next year. If the S&P 500 has no earnings growth at all in 2019, which is highly unlikely, stocks are trading at a relatively attractive valuation of about 15 times earnings. With earnings up over 20% this year, and stocks down, stock valuations are much cheaper than they were a year ago.

The markets are concerned about three factors: higher interest rates, trade wars, and political concerns about President Trump. Widespread concern has developed over the past few months that higher interest rates will slow or eliminate economic growth here in the U.S. and abroad. Markets are also fearful that global trade wars will slow economic growth and trigger a global recession. Finally, we believe that President Trump's recent actions have upset the financial markets. Whether you voted for him or not, it is troubling that he has made an abrupt change of strategy in Syria and the Middle East that led to the departure of Secretary of Defense Mattis. Next, he has been bullying Federal Reserve Chairman Jerome Powell, including threatening to fire him even though he clearly has no such authority. His bold statements that he was looking forward to shutting down the government, possibly for a long time, also did not help. The President has taken many actions that have helped our economy and our markets. Some find him refreshing and others find him scary. He is volatile and unpredictable.

President Trump measures his success in part by the Dow Jones Industrial Average. If he wants the markets to improve, and we believe he does, he should tone down criticism of Jerome Powell and he should be more thoughtful before he completely overrides some of the strongest members of his team.

Here is how we believe these issues are likely to be resolved:

- We expect a partial trade resolution between China and the U.S. over the next several months. Xi Jinping has long had too much to lose to go through a trade war. Now, President Trump also has too much to lose and, therefore, we expect a relatively quick, partial resolution.

- One way or another, the government will re-open fairly quickly. If the President smartens up a bit, he will accept additional funding for border security even though the Democrats will not let him call it a wall. If he does not move forward with this, Nancy Pelosi and company will arrive on January 3rd and the reality of two years of gridlock will set in. They will have to come to a resolution.

- The Federal Reserve has heard loud and clear from both the President and the market complaining about higher rates. We believe they will be particularly cautious as they raise rates at least two times during 2019. We believe the markets will gradually come to understand that the economy is strong enough to withstand the interest rate increases and it is necessary for the Federal Reserve to gradually end the massive manipulation that they have orchestrated for more than the last 10 years. The economy should be just fine and so should corporate earnings. Once the crisis of confidence has passed, stock prices will have a lot of room to recover.

In addition to the market weakness, there has been a big increase in day-to-day volatility. The decline on Christmas Eve was terrible, but on December 26th the market was up over 1,000 points. We believe hedge funds and other speculative trading driven by computer algorithms are responsible for much of the volatility. This short-term speculative trading can have a magnified effect on markets during holiday times when many market participants are away from their offices. The volatility is concerning to watch but we continue to believe that underlying fundamentals will ultimately prevail. For patient, long-term investors, this volatility sometimes creates great investment opportunities.

Most of you know that L. Roy Papp & Associates has long preferred American companies to most overseas markets. Even with our current political issues, we would observe that the U.S. economy is much stronger, and our country is politically and economically more stable than the U.K., Germany, France, or Japan. Most other foreign markets have even more political and economic issues to deal with.

During 2018, L. Roy Papp & Associates said goodbye to two longtime friends who retired, Enid and Phyllis. We were happy to welcome new additions, Lisa and Joanne. All of us here at L. Roy Papp & Associates, LLP wish you and your family a healthy, happy, and prosperous New Year.

Best regards,

Harry Papp
Managing Partner
December 31, 2018